BEFORE THE WASHINGTON STATE
OFFICE OF THE INSURANCE COMMISSIONER

In the Matter of THE APPLICATION REGARDING THE CONVERSION AND ACQUISITION OF CONTROL OF PREMERA BLUE CROSS AND ITS AFFILIATES.	No. G02-45 OIC STAFF'S POST-HEARING BRIEF

COMES NOW the Office of the Insurance Commissioner Staff (OIC Staff) by and through their attorneys of record, MELANIE C. deLEON, Assistant Attorney General, and JOHN F. HAMJE, Special Assistant Attorney General, and pursuant to the Twenty-fifth Order Extending Case Schedule, dated January 12, 2004, submits this post-hearing brief.

I. CASE PROCEDURAL HISTORY

In May 2002, Premera Blue Cross (hereafter "Premera") notified the Washington State Insurance Commissioner and the Attorney General of its intention to reorganize its holding company system to convert from a non-profit company to a for-profit company. *See* Exhibit S-71; S-96. On September 17, 2002, Premera filed its Form A Statement ("Form A") seeking approval for its proposed reorganization. *See* Commissioner's 1[1]. Thereafter, Premera supplemented its Form A on October 25, 2002 and January 21, 2003. In addition, on October 17, 2003, Premera further supplemented the Form A by filing its executive compensation

[1] All references to the Commissioner's Exhibits will hereafter be referred to as " Exhibit C-#." Citations to the hearing transcript shall hereafter be referred at "TR".

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(stock ownership) plan. *See* Exhibit. C-2, Exhibit G-10. Finally, after further discussions with the parties, Premera amended the Form A on February 5, 2004. *See* Exhibit C-2.

Premera requests approval for changes in control of its domestic health carriers and insurers by dissolving the non-profit corporations within the system and exchanging their assets for stock of a newly-created for-profit company, New Premera, thus resulting in a reorganization of Premera's holding company system. The proposed transaction is illustrated in Exhibit A-3(a) to the amended Form A Statement. *See* Exhibit C-2. The final steps in the proposal consist of New Premera transferring 100% of its initial stock to the Washington and Alaska foundation shareholders. *See* Exhibit C-2, Exhibit A-3(a).

Following lengthy discovery and eight public hearings around the state, this matter proceeded to hearing before the Insurance Commissioner from May 3, 2004, through May 18, 2004. 41 witnesses presented live testimony; 9 witnesses submitted unsworn testimony, and thousands of pages of documents and prefiled testimony were admitted into the record. The OIC Staff will not reiterate the extensive testimony in this portion of its post-hearing brief but rather will refer to applicable portions in its argument below.

II. ISSUES

A. Whether Premera's application should be denied because the transaction is not fair and reasonable in that the proposed transaction does not result in the transfer of the fair market value of Premera's assets to the foundation shareholders.

B. Whether Premera's application should be denied because the transaction treats subscribers unfairly and unreasonably, is not in the public interest and is likely to be hazardous to the insurance-buying public.

C. Whether Premera's application should be denied because the transaction will result in the entrenchment of the current board of directors and executive management, and thus is not in the best interests of subscribers, results in a hazard to the insurance buying public and is not in the public interest.

D. What is the proper allocation of assets between the States of Washington and Alaska?

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E. Whether, if the Commissioner determines to approve the conversion, additional conditions should be placed on the transaction.

III. LEGAL ARGUMENT

A. The Commissioner's consideration of Premera's Form A application is subject to the Washington Holding Company Acts and the Washington Nonprofit Corporation Act.

The Commissioner's consideration of Premera's Form A application is subject to review under chapters 48.31B and 48.31C RCW (the Washington Holding Company Acts) as well as chapter 24.03 RCW (the Washington Nonprofit Corporation Act).

1. RCW 48.31B.015(4)(a) and 48.31C.030(5)(a) provide that the Commissioner must affirmatively find that one or more bases for disapproval exist or the transaction must be approved.

RCW 48.31B.015 and 48.31C.030 apply to this transaction because the Form A application results in a change in control of several companies within Premera's holding company system including both domestic health carriers and domestic insurers. RCW 48.31B.015(1); 48.31C030(1); 48.31C.160. RCW 48.31B.015 applies to Premera's two domestic insurers involved in the transaction: LifeWise Assurance Company and LifeWise Health Plan of Arizona, Inc. *See* RCW 48.31C.160. Review under RCW 48.31C.030 is also necessary to determine the factors that apply to the health carriers in the Premera holding company system: Premera Blue Cross and LifeWise Health Plan of Washington. Specifically, the Commissioner shall approve the Form A unless he finds one or more of the following relevant portions of those acts form a basis for disapproval:

> 1. The plans or proposals that the acquiring party has to liquidate the health carrier or insurer, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to subscribers of the health carrier or policyholders of the insurer and not in the public interest;[2]

[2] RCW 48.31B.015(4)(a)(iv); 48.31C.030(5)(a)(ii)(C)(II).

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2. The competence, experience, and integrity of those persons who would control the operation of the health carrier or insurer are such that it would not be in the interest of subscribers of the health carrier or policyholders of the insurer and of the public to permit the merger or other acquisition of control;[3] or

3. The acquisition is likely to be hazardous or prejudicial to the insurance-buying public.[4]

In its prehearing brief, Premera argues that the relevant portions of RCW 48.31C.030 do not apply to this proceeding unless there is a demonstrated anticompetitive effect. *See* Premera's Hearing Brief, Appendix A. This argument is based upon a statutory interpretation that is flawed.[5]

First, Premera asserts that the transaction must be approved unless the Commissioner finds that after the change in control, the domestic health carrier will be unable to satisfy the requirements for registration or that there is substantial evidence that the effect of the change in control may substantially lessen competition or tend to create a monopoly. *Id.* at 32-33. Therefore, Premera's argument continues, that since there is no evidence that either factor is present, the Commissioner must approve the transaction. *Id.* at 35. Finally, Premera argues that because the remaining factors in RCW 48.31C.030 are subsumed under the antitrust inquiry provisions of RCW 48.31C.030(5)(a)(ii)(C), they apply only where the Commissioner has found that a transaction is anticompetitive. *Id.* at Appendix A, 3-4, 8.

In reviewing this claim, the Commissioner should turn to the plain language of the statute. To ascertain the legislative intent, it is necessary to examine the language chosen by the legislature.

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[3] RCW 48.31B.015(4)(a)(v); 48.31C.030(5)(a)(ii)(C)(III).

[4] RCW 48.31B.015(4)(a)(vi); 48.31C.030(5)(a)(ii)(C)(IV).

[5] There appears to be no dispute that all of the factors contained in RCW 48.31B.015 apply to the two domestic insurers involved in the transaction: LifeWise Assurance Company and LifeWise Health Plan of

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Fraternal Order of Eagles, Tenino Aerie No. 564 v. Grand Aerie of Fraternal Order of Eagles, 148 Wn.2d 224, 239, 59 P.3d 655, *cert. denied* 538 U.S. 1057 (2003). Here, RCW 48.31C.030(5)(a) provides, in relevant part, as follows:

> The commissioner shall approve an acquisition of control ... unless, after a public hearing, he or she finds that:
>
> . . .
>
> (ii) The antitrust section of the office of the attorney general and any federal antitrust enforcement agency has chosen not to undertake a review of the proposed acquisition and the commissioner pursuant to his or her own review finds that there is substantial evidence that the effect of the acquisition may substantially lessen competition or tend to create a monopoly in the health coverage business.
>
> If the antitrust section of the office of the attorney general does not undertake a review of the proposed acquisition and the review is being conducted by the commissioner, then the commissioner shall seek input from the attorney general throughout the review.
>
> If the antitrust section of the office of the attorney general undertakes a review of the proposed transaction then the attorney general shall seek input from the commissioner throughout the review. As to the commissioner, in making this determination:
>
> . . .
>
> (B) The commissioner may not disapprove the acquisition if the commissioner finds that:
>
> (I) The acquisition will yield substantial economies of scale or economies in resource use that cannot be feasibly achieved in any other way, and the public benefits that would arise from the economies exceed the public benefits that would arise from more competition; or
>
> (II) The acquisition will substantially increase or will prevent significant deterioration in the availability of health care coverage, and the public benefits of the increase exceed the public benefits that would arise from more competition;
>
> (C) The commissioner may condition the approval of the acquisition on the removal of the basis of disapproval, as follows, within a specified period of time:

Arizona, Inc. Premera's Hearing Brief at 30 n. 9; *see* RCW 48.31C.160. The dispute arises only with respect to the factors that apply to the health carriers: Premera Blue Cross and LifeWise Health Plan of Washington.

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> (I) The financial condition of an acquiring party is such as might jeopardize the financial stability of the health carrier, or prejudice the interest of its subscribers;
> (II) The plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to subscribers of the health carrier and not in the public interest;
>
> (III) The competence, experience, and integrity of those persons who would control the operation of the health carrier are such that it would not be in the interest of subscribers of the health carrier and of the public to permit the merger or other acquisition of control; or
>
> (IV) The acquisition is likely to be hazardous or prejudicial to the insurance-buying public.

Subsections (B) and (C) above both include language relating to the Commissioner's antitrust inquiry. These provisions are introduced with the language: "As to the commissioner, in making this determination ...." The words "this determination" relate to the result of the Commissioner's antitrust inquiry. RCW 48.31C.030(5)(a)(ii). Subsection (B) provides that if he finds that the test set forth in either (B)(I) or (B)(II) is met, he may not disapprove the transaction regardless of whether he has finds that "substantial evidence that the effect of the acquisition may substantially lessen competition or tend to create a monopoly in the health coverage business." Both tests contained in subsection (B) substantively relate to the antitrust inquiry and authorize the Commissioner to weigh the public benefits that may be gained from the change in control against the public benefits that would be gained from more competition. The legislature intended that the Commissioner exercise his discretion rather than disapprove a transaction merely because it would result in lessening competition.

In contrast, subsection (C) presents a different consideration. None of the articulated bases of disapproval set out in (C)(I), (C)(II), (C)(III), or (C)(IV) apply by their terms to an antitrust inquiry. They appear entirely unrelated to the inquiry particularly in light of the use in

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RCW 48.31B.015(4)(a)(iii), (iv), (v), and (vi), of substantially similar language as stand-alone grounds for disapproval. When similar words are used in different parts of a statute, it is presumed that the legislature intended the meaning to be the same throughout. *DeGreif v. Seattle,* 50 Wn.2d 1, 20, 297 P.2d 940 (1956). The language used in the former statute, RCW 48.31C.015 (4)(a), was not conditioned in any way or even related to the antitrust inquiry. The provisions contained in RCW 48.31C.030(5)(a)(ii)(C) should be given a similar meaning and applied in the same way. Merely subsuming them under the antitrust inquiry provisions does not compel the conclusion that they should be applied any differently than the corresponding provisions in RCW 48.31B.015.

Further, it makes no sense to condition approval of a transaction that is deficient for anticompetitive reasons upon one of the grounds set forth in RCW 48.31C.030(5)(a)(ii)(C). For instance, what anticompetitive finding may be cured with a conditional approval that speaks to the "competence, experience, and integrity" of those who would control the target health carrier? RCW 48.31C.030(5)(a)(ii)(C)(III). The same may be asked about each of the other bases.[6] Premera's interpretation would render these provisions superfluous. In construing a statute, no part should be deemed inoperative or superfluous unless the result of an obvious error. *Cox v. Helenius,* 103 Wn.2d 383, 387-388, 693 P.2d 683 (1985). The OIC Staff's construction of these provisions supports their robust application in Form A proceedings.

In addition, if Premera's interpretation is accepted, the Commissioner would be authorized only to review a transaction under RCW 48.31C.030(5)(a)(i) without any

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consideration of the bases of disapproval set out in RCW 48.31C.030(5)(a)(ii)(C), if the Attorney General or any federal antitrust enforcement agency undertook a review of the transaction. Taking into consideration the broad scope of these bases, it seems unlikely that the legislature intended to so hamstring the Commissioner.

Assuming for the purpose of argument only that Premera's proposition that the bases for disapproval set forth in RCW 48.31C.030(5)(a)(ii)(C) are not stand-alone provisions, the language utilized by the legislature does not compel the conclusion that the bases for disapproval are only triggered upon an anticompetitive finding. Premera's Hearing Brief, Appendix A at 4. The introductory language does not condition what follows 4 upon such a finding. "As to the commissioner, in making this determination" requires that the commissioner take into consideration the provisions that follow in formulating his finding regarding the antitrust inquiry. He must determine whether the tests contained in RCW 48.31C.030(5)(a)(ii)(B) are satisfied. If they are, he cannot disapprove the transaction on anticompetitive grounds. He must also consider the bases for disapproval set out in RCW 48.31C.030(5)(a)(ii)(C). If he finds that one or more are applicable, he may either disapprove the transaction or condition approval if the basis or bases are removed *within the context of his antitrust inquiry*. Reliance upon the words "as follows" contained in RCW 48.31C.030(5)(a)(ii)(C) to establish that the bases for disapproval are conditioned upon a threshold anticompetitive finding is misplaced. The words merely signal that what follows is a list of the bases for disapproval. Therefore, the Commissioner may rely upon these bases in

[6] Although it is arguable that the bases for disapproval contained in RCW 48.31C.030(5)(a)(ii)(C)(II) and (IV) encompass anticompetitive findings, that is only possible due to the broad sweep of the language used by the legislature. This is consistent with their use outside of the antitrust context in RCW 48.31B.015(4)(a).

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connection with making a finding regarding his antitrust inquiry. They are effectively stand-alone bases for disapproval that represent components of the Commissioner's antitrust inquiry.

Even if Premera's interpretation concerning RCW 48.31C.030(5)(a)(ii)(C) were correct, it does not take into consideration the authority granted to the Commissioner under RCW 48.31C.030(5)(c) which provides: "The commissioner may condition approval of an acquisition on the removal of the basis of disapproval within a specified period of time." The "basis of disapproval" includes those defined as in RCW 48.31C.030(5)(a)(ii)(C) as well as RCW 48.31C.030(5)(a)(i) and (ii). It is a stand-alone provision that allows the Commissioner to use without limitation any basis of disapproval as a condition of approval. In this way, it differs from similar language used by the legislature in RCW 48.31B.015(4)(a)(ii)(C). Thus, since the Commissioner may use those bases of disapproval listed in RCW 48.31C.030(5)(a)(ii)(C) as conditions for approval, he may also disapprove a transaction on one or more of these bases without regard to any anticompetitive finding.

2. Under RCW 48.31B.030 and 48.31C.050, Premera must demonstrate that the terms of the application are fair and reasonable.

RCW 48.31B.030 and 48.31C.050 apply to the application because that the domestic insurers (LifeWise Assurance Company and LifeWise Health Plan of Arizona, Inc.) and domestic health carriers (Premera Blue Cross and LifeWise Health Plan of Washington) are parties to the proposed transaction. RCW 48.31B.030(1)(a); 48.31C.050(1). Thus, the terms of the transaction must be fair and reasonable. RCW 48.31B.030(1)(a)(i); 48.31C.050(1)(a).

Premera argues for a narrow construction of the so-called "Form D" provision applicable to domestic health carriers by claiming it only applies to those transactions listed in RCW 48.31C.050(2) where the transaction is not subject to approval elsewhere within

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title 48 RCW.[7] Premera's Hearing Brief at 57, n. 36. Therefore, the argument is made, none of the standards set out in RCW 48.31C.050(1) apply. This is not a correct interpretation of the applicable provisions.

RCW 48.31C.050 provides, in pertinent part, as follows:

> (1) Transactions within a health carrier holding company system to which a health carrier subject to registration is a party are subject to the following standards:
>
> (a) The terms must be fair and reasonable;
>
> . . .
>
> (2) The following transactions, excepting those transactions which are subject to approval by the commissioner elsewhere within this title, involving a domestic health carrier and a person in its health carrier holding company system may not be entered into unless the health carrier has notified the commissioner in writing of its intention to enter into the transaction and the commissioner does not declare the notice to be incomplete at least thirty days before, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period. Unless the commissioner declares the notice to be incomplete and requests additional information, the notice is deemed complete thirty days after receipt of the notice by the commissioner. If the commissioner declares the notice to be incomplete, the thirty-day time period in which the notice is deemed complete shall be tolled until fifteen days after the receipt by the commissioner of the additional information:
>
> (a) Sales, purchases, exchanges, loans or extensions of credit, guarantees, or investments if the transactions are equal to or exceed the lesser of (i) two months of the health carrier's annualized claims and administrative costs, (ii) five percent of the health carrier's admitted assets, or (iii) twenty-five percent of net worth, as of the 31st day of the previous December;
>
> . . .
>
> (d) Management agreements, service contracts, and cost-sharing arrangements;
>
> . . .
>
> (4) The commissioner, in reviewing transactions under subsection (2) of this section, shall consider whether the transactions comply with the standards set forth in subsection (1) of this section.

[7] Premera implies that the standards enumerated in RCW 48.31B.030(1) are applicable to this transaction since the limitation language relied upon in RCW 48.31C.050(2) is not present. Premera's Response to the OIC Staff's Prehearing Memoranda at 3, n. 2. OIC Staff's position is that RCW 48.31B.030(1) applies to the Form A.

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Subsection (1) contains the general rule applicable to all transactions within a health carrier holding company system. All regulated companies must adhere to the standards set forth in this subsection. Failure to do so may result in sanctions. *See, e.g.,* RCW 48.31C.080, .090, .120.

Subsection (2) establishes a procedure for a health carrier to obtain prior approval for certain enumerated transactions. The transactions may not be consummated until the carrier notifies the Commissioner. The transaction is deemed approved if the Commissioner fails to take certain actions within the prescribed periods of time. The subsection excludes from this procedure "those transactions which are subject to approval by the commissioner elsewhere within this title." That means that where a different procedure is required for approval, such as that mandated by RCW 48.31C.030(4), that procedure must be followed rather than the strict deemer provisions contained in subsection (2). This provision is necessary to prevent conflict between dissimilar statutory procedural requirements.

Subsection (4) provides that when a transaction is submitted and reviewed under subsection (2), the Commissioner is required to consider the standards set out in subsection (1). Subsection (4) does not limit the application of the standards set forth in subsection (1). It merely specifies that those standards be applied under the procedures established by subsection (2).

If Premera's narrow interpretation of these provisions is accepted, it would mean that the Commissioner could not enforce the standards set out in subsection (1) except where a health carrier submitted the transaction for prior approval under the procedure established in subsection (2). Thus, if the transaction were subject to the approval of the Commissioner

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under RCW 48.31C.030, the standards would not apply. Premera's Hearing Brief at 57, n. 36. This result is inconsistent with the authority granted to the Commissioner in chapter 48.31C RCW. The Commissioner may enforce the standards established in subsection (1) without regard to whether the health carrier obtained approval for the transaction under the procedures set out in subsection (2). RCW 48.31C.090(3) provides that if a health carrier "has engaged in a transaction or entered into a contract that is subject to RCW 48.31C.050 and 48.31C.060 and that would not have been approved had approval been requested," the Commissioner may issue a cease and desist order or void such contract.[8] This means the Commissioner may apply the standards set forth in RCW 48.31C.050(1) in determining whether the transaction would have been approved. The legislature did not limit the application of this provision to transactions under RCW 48.31C.050(2) but, instead referenced the entire section. Therefore, it did not exclude from the embrace of this statute those transactions which may be applied under RCW 48.31C.030. In fact, the legislature prohibited the application of RCW 48.31C.090 to acquisitions under RCW 48.31C.020. RCW 48.31C.090(6). If it had not intended that the standards be enforced in a Form A proceeding, the legislature would also have excluded RCW 48.31C.030. *See Bour v. Johnson,* 122 Wn.2d 829, 836, 864 P.2d 380 (1993) ("Legislative inclusion of certain items in a category implies that other items in that category are intended to be excluded.").

[8] The Form A is subject to both RCW 48.31C.050 and 48.31C.060.

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3. The provisions of RCW 24.06.265 and Premera's Articles of Incorporation apply to the Application because they require Premera to distribute its net assets as part of any dissolution.

RCW 24.06.265 requires Premera to transfer its assets to another nonprofit organization. In this case, Premera has selected a Washington and Alaska foundation to transfer its assets. *See* Exhibit C-2. Finally, Premera's own Articles of Incorporation also require such a transfer. *See* TR 1282-83, 2118-19, 2120-21; Exhibit P-87 at 20-21.

B. Premera's application should be denied because the transaction is not fair and reasonable in that the proposed transaction does not result in the transfer of the fair market value of Premera's net assets to the foundations shareholders.

A determination of whether Premera's net assets are subject to a charitable trust analysis is irrelevant because Premera has conditioned its application on transfer of fair market value.

Premera's application contemplates the creation of two nonprofit foundations that are the intended recipients of Premera's net assets upon its dissolution. As such, the Commissioner must review the transaction to ensure that the value of Premera is preserved for lawful uses under RCW 24.03.225(3). *See generally* Exhibit I-2. The Attorney General, rather than the Commissioner, is responsible for determining the ultimate use of the distributed assets. RCW 24.03.230. In addition, the Attorney General is exclusively responsible for determining to what extent, if any, Premera's assets are subject to charitable use restrictions whether imposed by statute or by common law. *Id.* Premera's application is structured to avoid the necessity of making this determination since it is intended to transfer the fair market value of Premera's assets to the foundation shareholders upon dissolution. Therefore, the Commissioner's role is to ascertain whether the Form A application will bring about the intended result. *See* Exhibit I-2 at 3.

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RCW 48.31B.030(1)(a)(i) states, in relevant part, that "transactions within a holding company system to which an insurer subject to registration is a party . . . must be fair and reasonable." Similarly, RCW 48.31C.050(1)(a) states that "transactions within a health carrier holding company system to which a health carrier subject to registration is a party . . . must be fair and reasonable." Under Premera's current plan of conversion, and for the reasons argued at the hearing, the terms of the transaction are not fair and reasonable and should be disapproved by the Commissioner.

Regardless of whether Premera is willing to concede that it is obligated to transfer its assets to one or more non-profit corporations under RCW 24.03.225(3) or the common law charitable trust or *cy pres* doctrines, it is required to do so under its Articles of Incorporation and RCW 24.03.225(4) and (5). TR 1282-83, 2118-19, 2120-21; Exhibit P-87 at 20-21. Testimony from Patrick Cantilo, the OIC Staff's legal consultant, as well as Premera's own legal expert, John Steel, is unanimous that transfer of 100 percent of the stock in New Premera to the Washington and Alaska Foundations is equivalent to transfer of fair market value. TR 1287-88, 2045-49, 2093-94.

Further, Premera's own documents contradict the position that Premera appears to take throughout the hearing. The initial Form A application stated that

> PREMERA will adopt and its sole member, the Foundation Shareholder, will approve a Plan of Reorganization and Plan of Distribution pursuant to which PREMERA will dissolve and distribute 100% of its assets, including all the stock of New PREMERA to the Foundation Shareholder."

Exhibit C-1 at 15, item 7(c) (emphasis added). Premera's revised Form A filed on February 5, 2004 contained more narrow language:

> PREMERA will adopt and its members, the Washington Foundation Shareholder and Alaska Health Foundation, will approve a Plan of Reorganization and Plan of

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> Distribution pursuant to which PREMERA will dissolve and distribute 100% of its assets, consisting of all the stock of New PREMERA to the Washington Foundation Shareholder and Alaska Health Foundation.

Exhibit C-2 at 17, item 7(c) (emphasis added). Premera's counsel confirmed that a consequence of approval of the Form A would be the transfer of fair market value to the Washington and Alaska Foundations.

> Premera has agreed only that it will transfer 100% of its stock to the Foundation Shareholders, which represents the fair market value of the company upon consummation of the conversion transaction.

Exhibit S-86 at 3 of Exhibit 7 (emphasis added). Since the Form A application contemplates that fair market value will be transferred to the foundation shareholders, any discussion of whether Premera's net assets are subject to charitable trust limitations is irrelevant. TR 206-07, 2084, 2100; Exhibit I-5 at 3.

Next, the structure of Premera's proposal serves to reduce the fair market value of the net assets. The Form A application includes a Registration Rights Agreement (Exhibit C-2 at G-5), the Voting Trust and Divestiture Agreement (Exhibit C-2 at G-4), and the Transfer, Grant and Loan Agreement (Exhibit C-2 at G-3). By these documents Premera imposes restrictions upon the stock to be transferred to the foundations' shareholders. These documents restrict when or if the stock can be sold, how to sell the stock, and rights accompanying the stock. These restrictions represent a substantial impediment to the transfer of fair market value of the stock to the foundations. TR 1367, 1382-83, 1480, 2119. *See Mailloux v. Commissioner of Internal Revenue,* 320 F.2d 60, 62 (5th Cir. 1963) (restrictions on stocks may adversely impact the fair market value of that stock).

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The following restrictions have a negative impact on the fair market value of the stock to be transferred to the foundations and thus should result in the Commissioner's disapproval of the application.

1. The Unallocated Shares Escrow Agreement (USEA) requires the Washington Foundation to sell not less than 10% of its stock in the initial public offering, forcing the foundation to sell at a time when the stock price may be low or unacceptable[9]. TR 1475-78, 2051-52.

2. The Voting Trust and Divestiture Schedule treats both the Washington and Alaska foundations as one entity. By applying the divestiture requirements to both foundations in the aggregate, the Washington foundation may be forced to sell a portion of its shares at an unfavorable time or at an unfavorable price if, for any reason, the Alaska foundation elects not to sell any or a sufficient amount by the deadlines. TR 1486-69, 2052-55. This results then in an unacceptable risk to the Washington foundation of not achieving full market value.

3. In the Voting Trust and Divestiture Schedule, the Washington foundation would be denied a free vote of its shares in transactions involving the acquisition or exchange of substantial equity in New Premera unless the transactions involve more than 50% of New Premera's equity. TR 1465-66.

Furthermore, Premera's self-described plan to seek the amount of $100 to $150 million in an initial public offering (IPO) will substantially dilute the value of the Washington foundation's stock in New Premera. TR 915-16, 1363-64, 1370-72. Based on these

[9] The price of stock during an IPO may be artificially low to attract buyers. This discount may be as high as 15%. TR 1371, TR 2052.

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restrictions, Premera's plans to dissolve and distribute its assets to the foundations are unfair and unreasonable to policyholders and are subject to disapproval on this issue alone.

C. The Commissioner must disapprove the Form A application because the economic impact of Premera's plans to convert is unfair and unreasonable to subscribers of the health carrier or policyholders of the insurer and because this conversion is likely to be hazardous to the insurance-buying public.

The evidence from the hearing demonstrated that in many parts of Eastern Washington, Premera has the market power to raise premiums above competitive levels. Because Premera has not sufficiently addressed this risk to subscribers or the insurance buying public, this application must be denied.

Market power is the power to control prices.[10] Ordinarily, market power is proven by circumstantial evidence. *Image Technical Serv. v. Eastman Kodak Co.*, 125 F.3d 1195 (9th Cir. 1997) (*"Kodak"*); *Rebel Oil Co., Inc. v. Atlantic Richfield Co.*, 51 F.3d 1421, 1434 (9th Cir.1995) (*"Rebel Oil"*). To demonstrate market power circumstantially, a party must: (1) define the relevant market, (2) show that the defendant owns a dominant share of that market, and (3) show that there are significant barriers to entry and show that existing competitors lack the capacity to increase their output in the short run." *Rebel Oil*, 51 F.3d at 1434. In this proceeding, Dr. Keith Leffler demonstrated, on the basis of the *Rebel Oil* factors, that Premera has market power over premiums in many parts of Eastern Washington.

1. Definition of The Relevant Market.

The definition of the relevant market requires proof of the product or service that is the subject of the market ("product market"), and of the geographic area in which the firm is

[10] Few Washington state court decisions address issues of market power, but there are many pertinent federal decisions. Resort to federal antitrust law is expressly authorized by the Legislature. The Legislature intended Washington's antitrust laws to complement the body of federal antitrust law and, in construing the state

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alleged to have market power ("geographic market"). The relevant product market encompasses "all products that are 'reasonably interchangeable,' and so can be said to compete with each other for the same buyers' dollars ...." *Murray Publishing v. Malmquist,* 66 Wn. App. 318, 832 P.2d 493 (1992), *quoting General Business Sys. v. North Am. Philips Corp.*, 699 F.2d 965, 972 (9th Cir. 1983); *see also U.S. v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 394-395 (1956). The geographic market is the area of effective competition within which buyers can turn for alternative sources of supply. *Murray Publishing v. Malmquist,* 66 wn. App. at 326. The geographic market inquiry attempts to define the area in which customers of the subject firm reasonably can find alternative sellers of the product if the subject firm raises its price or restricts its output.

This state law definition of the relevant market is entirely consistent with the definition used by the primary federal antitrust enforcement agencies, as stated in the *Horizontal Merger Guidelines* of the U.S. Department of Justice and the Federal Trade Commission (hereinafter the "*Merger Guidelines*"). The *Merger Guidelines* provide that the relevant market is defined by examining likely consumer responses to an increase in the price of the subject product by a hypothetical firm having a monopoly over the product:

> Absent price discrimination, a relevant market is described by a product or group of products and a geographic area. In determining whether a hypothetical monopolist would be in a position to exercise market power, it is necessary to evaluate the likely demand responses of consumers to a price increase. A price increase could be made unprofitable by consumers either switching to other products or switching to the same product produced by firms at other locations. The nature and magnitude of these two types of demand responses respectively determine the scope of the product market and the geographic market.

Merger Guidelines, Exhibit P-96 at 6-7.

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laws, state courts are to be guided by federal decisions dealing with the same or similar matters. RCW 19.86.920; *Boeing Co. v. Sierracin Corp.*, 108 Wn.2d 38, 738 P.2d 665 (1987).

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In defining the relevant markets, Dr. Leffler applied the definition described in *Murray Publishing v. Malmquist* and in the *Merger Guidelines*. He defined the markets to include commercial insurance to individuals, small groups and large groups in regional areas in Washington. TR 1756-57. He separated commercial insurance from governmental insurance like Medicare, Medicaid and the Basic Health Plan, because consumers with commercial plans will not likely be able to switch to governmental coverage in response to a price increase. TR 1758. For the same reason, he treated individual, small group and large group as separate products. TR 1760. Consumers cannot switch between these types of coverage. The regions constituting the geographic market areas are defined by how far consumers would travel to obtain health care. TR.1757-58. Dr. Leffler's definitions of the relevant markets are supported by common sense, as well as by the foregoing legal authorities.[11]

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[11] During cross-examination of Dr. Leffler, Premera suggested incorrectly that the court in *Rebel Oil* ruled that a relevant market should be defined on the basis of supply considerations, as well as on the basis of the demand considerations specified in the *Merger Guidelines*. Although the *Rebel Oil* court did state in dictum that market definition should include supply considerations, that is not what the court did. The issue was whether the product market should include both self-service gasoline sales and full-service sales. The court did not rule that consumers would switch from self serve to full serve, so that full-service should be included in the product market. It ruled that full-service pumps could easily at virtually no cost be converted to self serve. Therefore it included the market share of full serve pumps in computing shares of the market. The court's dictum overlooks the subtle distinction between defining the market and identifying participants in the market. The court did not expand the product market to include full serve – it determined that full-service pumps could be easily be brought into the self serve product market. The distinction overlooked by the court is expressly addressed in the *Merger Guidelines*:

> "Once defined, a relevant market must be measured in terms of its participants and concentration. Participants include firms currently producing or selling the market's products in the market's geographic area. In addition, participants may include other firms depending on their likely supply responses to a 'small but significant and nontransitory' price increase. A firm is viewed as a participant if, in response to a 'small but significant and nontransitory' price increase, it would likely enter rapidly into production or sale of a market product in the market's area, without incurring significant sunk costs of entry and exit. Firms likely to make any of these supply responses are considered to be 'uncommitted entrants' because their supply response would create new production or sale in the relevant market and because that production or sale could be quickly terminated without significant loss."

Exhibit P-96 at 8-9. Thus, notwithstanding the *Rebel Oil* court's dicta, its holding on market measurement is consistent with the *Merger Guidelines*. Given the court's conclusions about the ease of converting full-serve

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2. Market Dominance in Areas of Eastern Washington.

Dr. Leffler properly concluded that Premera has market dominance in selling individual and small group plans in the fourteen counties in Eastern Washington in which it has both the BCBSA trade marks. TR 1764.[12] Premera's market share in these markets exceeds 80 percent in every case and 90 percent in most cases. Exhibit S-112. Given that a market share of 65 percent generally creates a *prima facie* case of market dominance, Dr. Leffler's conclusions about Premera's market dominance in these counties in Eastern Washington is clearly well-founded.

3. Barriers To Entry And Expansion In Eastern Washington Are Supported By Extensive Evidence.

Proving market power on the basis of dominant market share involves showing that new competitors face barriers to entry and that current competitors lack the ability to expand their output to challenge a dominant firm's increased prices. *Kodak*, 125 F.3d at 1208. The purpose is to show that the monopoly power will not likely be self-corrected by the market. *Id.*

Dr. Leffler determined that there are several barriers to entry and expansion in Eastern Washington. First, he pointed to switching costs. Consumers do not want to have to change doctors in response to a small premium increase, so competing plans would have to offer a provider network as large as Premera's extensive network. TR 1765. Also, employers providing coverage face administrative costs of switching carriers. TR 1765. In addition, the small size of the markets in many areas of Eastern Washington make it unlikely that Premera would face new competition in response to a five to ten percent price increase. TR 1765.

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pumps to self serve, the full serve sellers were "uncommitted entrants" whose market shares were properly included in the measurement of market shares and concentration under the Guidelines.

[12] It should be noted that Dr. Leffler did not consider counties to necessarily constitute the relevant geographic markets. The OIC data used to calculate market shares is reported by county. TR 1759. Dr. Leffler testified that in some instances like Spokane, metropolitan areas would be the appropriate markets. In others it

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Finally, Dr. Leffler demonstrated that Premera's control of the Blue Cross and Blue Shield brands gave it a significant advantage in the fourteen-county area. Premera's own market shares in the fourteen counties are much higher than its shares in other Eastern Washington counties, where it faces competition from other "Blue plans." Exhibit S-112. Dr. Leffler also observed that Regence's market shares in Eastern Washington were greatly affected by whether it has the Blue brand. In those counties in which it can use the Blue Shield trade mark, its market share averaged 30 percent, but in the other counties its share averaged only six percent. TR 1766.

The United States Supreme Court has recognized the practical reality that switching costs can force customers of a dominant seller to tolerate price increases. *Eastman Kodak Co. v. Image Technical Services*, 504 U.S. 451, 112 S.Ct. 2072, 119 L.Ed.2d 265 (1992). Also, it is well established that entry barriers include entrenched buyer preferences. *Kodak*, 125 F.3d at 1208; *Rebel Oil,* 51 F.3d at 1439; *see also U.S. Philips Corp. v. Windmere Corp.*, 861 F.2d 695 (D.C.Cir. 1988); *Avery Dennison Corp. v. Acco Brands Inc.*, 2000 WL 986995 (C.D.Cal. 2000).

4. The market share analysis of Premera's economist is simply not credible.

In striking contrast to Dr. Leffler's careful analysis, Dr. McCarthy offered a market-share theory that ignores basic economic and legal principles and the realities of the market in Eastern Washington. In order to justify a market share under 28 percent for Premera as a seller of health plans, Dr. McCarthy grouped together commercial and governmental coverage, and individual and small and large group plans. TR 527. Dr. McCarthy admitted that buyers of commercial plans could not likely switch to governmental coverage, and, for

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would be counties. But his market share calculations for Eastern Washington were not affected by whether he used metropolitan areas, counties or groups of counties. TR 1757–58.

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example, that consumers under small-group coverage were limited in their ability to switch to individual or large-group plans. TR 577. Yet he grouped together all of these types of coverage anyway.

There are situations in which groups of non-interchangeable products may be aggregated to form a single relevant market. For example, in *U.S. v. Philadelphia Nat'l Bank*, 374 U.S. 321, 83 S. Ct. 1715, 10 L. Ed. 2d 915 (1963), the Supreme Court grouped various banking services, including checking accounts, credit functions, and trust administration under the category of commercial banking services. But the relevant market definition must be based on commercial realities faced by consumers. *Eastman Kodak Co. v. Imaging Technical Services, supra,* 504 U.S. at 480. As the Court said in *U.S. v. Grinnell Corp.*, 384 U.S. 563, 572, 86 S. Ct. 1698, 16 L. Ed. 2d 778 (1966): "We see no barrier to combining in a single market a number of different products or services where that combination reflects commercial realities."

In its *Kodak* decision, the Ninth Circuit elaborated on this issue, quoting from its opinion in *JBL Enterprises, Inc. v. Jhirmack Enterprises*, 698 F.2d 1011 (1983):

> We commented that a "cluster approach is appropriate where the product package is significantly different from, and appeals to buyers on a different basis from, the individual products considered separately."

125 F.3d at 1204-05.

Dr. McCarthy's theories run counter to these authorities. Grouping the different types of coverage is entirely inconsistent with the realities facing consumers, whether viewed from the perspective of individuals or employers. Virtually no one switches between commercial and governmental coverage, or between individual and small and large group plans. The

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same obvious flaws infect his defined geographic market, which encompasses the entire state. Virtually no one goes from Spokane to Seattle – or to Clark County – to obtain basic health care, yet Premera's economist includes the whole state in a single market. While this approach does mask Premera's dominance in Eastern Washington, it is hardly consistent with the realities facing consumers. Thus it is not surprising that Dr. Gold concluded that Dr. Leffler's market-share analysis is more reasonable than that of Premera's economist, (TR 1956-57) and that Dr. Gold used Dr. Leffler's market shares in his study. TR 1958.

Dr. McCarthy's analysis was based in substantial part in purported instances of product line expansion by insurers, and geographic expansion into Eastern Washington. On the basis of this evidence, he asserted that entry into Eastern Washington is easy. TR 524-26. Dr. Leffler reviewed the evidence relied on by Dr. McCarthy. He concluded that this evidence did not include a single instance of successful expansion into Eastern Washington or successful expansion into commercial insurance by an insurer previously specializing in governmental coverage. TR 1766-69.[13]

Dr. Leffler testified that he defined the relevant markets using the analytical framework of the *Merger Guidelines*. TR 1753-56. Under the *Merger Guidelines*, the relevant market is defined solely on the basis of alternatives available to consumers:

> Market definition focuses solely on demand substitution factors – i.e., possible consumer responses. Supply substitution factors – i.e., possible production responses – are considered elsewhere in the Guidelines in the identification of firms that participate in the relevant market and the analysis of entry.

Exhibit P-96 at 7.

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[13] In his pre-filed responsive testimony, Dr. Leffler provided an even more thorough review of Dr. McCarthy's purported instance of entry and expansion. Exhibit S-54 at 7-11. Dr. Leffler demonstrated that of the 19 purported instances of entry and expansion cited by Dr. McCarthy, only the entry of Regence Asuris has any

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Premera's economist based his statewide, all-products market on two flawed assumptions. First, as discussed above, he wrongly interpreted purported instances of expansion and entry and concluded that entry into Eastern Washington is easy. Dr. Leffler's testimony included the point-by-point refutation of these incorrect interpretations cited above. Second, Dr. McCarthy claimed that the DOJ and FTC do not actually apply the *Merger Guidelines* as they are written. Instead, he claimed that the agencies consider supply responses in defining relevant markets. This claim is not only clearly inconsistent with the unambiguous text of the *Guidelines*. It is also inconsistent with the one case referred to by Dr. McCarthy in this connection, *U.S. v. Aetna Inc. and The Prudential Insurance Co.* (hereafter "*Aetna*"). As Dr. McCarthy conceded in his testimony, (TR 581-86), in *Aetna*:

1. The DOJ did not define the product market to include commercial and governmental products. The market included only commercial products.

2. The DOJ did not even include both HMO and PPO products. The defined market was limited to HMO products.

3. The geographic market was limited to the counties included in the Dallas-Ft. Worth and Houston MSA, not the whole state.

Further, in considering the weight to give Dr. McCarthy's unsubstantiated claim that the DOJ and FTC apply the *Guidelines* contrary to the way that the agencies wrote them, the Commissioner should take into account the relative experience of Dr. Leffler and Dr. McCarthy in this area. In the past four years alone, Dr. Leffler has testified in deposition or trial in the 28 cases. *See generally* Exhibit S-16. In addition, he has consulted with the DOJ or FTC in 16 different cases, beginning with the FTC investigation of the Chevron-Gulf Oil merger, and continuing through his work on *U.S. v. Microsoft*. Most of these cases and

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significance. And the market penetration by unbranded Asuris is a fraction of the penetration by Regence in the counties in which it sells as Blue Shield.

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investigations required his analysis of the relevant market, (TR 1749-50), and in all of his work for the federal enforcers and in other cases he has used the approach described in the *Merger Guidelines* for defining relevant markets. TR 1756. Dr. McCarthy has never been retained to work on a case by the FTC or DOJ. TR 592-93.

Even if there were some doubt about the soundness of Dr. Leffler's approach, which there is not, the Commissioner should consider which economist is generally more credible. Dr. Leffler offered a balanced analysis based on a careful investigation that included field interviews of more than 50 executives and managers of firms participating in the Washington health care market. Exhibit S-17 at 9. These firms included seven brokerage firms, nine competing health carriers, twelve hospitals and physicians clinics, four large buyers, and Premera. Dr. Leffler's conclusions reflect his impartial approach to his investigation: some favor Premera and some disfavor Premera. For example, he found that Premera has no market power in Western Washington; that it has market power as a seller in Eastern Washington but that power is constrained by OIC regulations and Premera's pricing policies, and that Premera has exercised market power as a buyer in Eastern Washington.

Dr. McCarthy's 'field investigation' consisted of three telephone interviews with brokers, each lasting 30 to 45 minutes. Neither he nor anyone else at NERA spoke with a single physician, hospital, buyer, or insurer other than Premera except for one broker that offers limited coverage. TR 605-07. With regard to the impartiality and balance of Dr. McCarthy's work, the Commissioner will be hard pressed to find a single thing that Dr. McCarthy has said that disfavors Premera, except for some of his concessions during his cross examination.

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5. The evidence of Premera's market power on the buying side is even more compelling.

Looking at whether Premera has market power as a buyer of provider services, Dr. Leffler found that Premera not only dominates the market in Eastern Washington, but that it has exploited its dominance. Premera's market share there is 73 percent, or 70 percent if estimated self-insurance is taken into account. TR 1771-72. There is no OIC regulation to constrain Premera's use of its dominance on the buying side. Dr. Leffler demonstrated that Premera has exploited its dominance in two ways. First, he compared Premera's provider fees in the Spokane area to those of Regence Asuris and First Choice. TR 1772-73, 1775-76, Exhibit S-115.

Second, he compared Premera's reimbursements in Eastern Washington, where it is dominant, to its reimbursements in Western Washington, where it is not dominant.[14] These comparisons showed Premera's actual exercise of its market power in Eastern Washington. TR 1776-77.

In *U.S. v. Microsoft Corp.*, the Court of Appeals for the D.C. Circuit affirmed a finding of an entry barrier based on interrelated brand preferences for Windows of both consumers and software developers:

> That barrier--the "applications barrier to entry"--stems from two characteristics of the software market: (1) most consumers prefer operating systems for which a large number of applications have already been written; and (2) most developers prefer to write for operating systems that already have a substantial consumer base.

[14] During cross examination of Dr. Leffler, counsel for Premera referred to testimony by Audrey Halvorson that Dr. Leffler's analysis of Premera's reimbursements based on its area factors did not take into account that the area factors reflect more than provider reimbursements. Ms. Halvorson said the same thing in her pre-filed direct testimony, and Dr. Leffler showed in his pre-filed responsive testimony that her criticism was ill-founded. Exhibit S-54 at 14-17. Dr. Leffler examined whether the other elements of Premera's area factors would affect his results significantly and determined that they did not. *Id.* Further, to eliminate any possible doubt he specifically asked Premera whether his analysis was correct, and Premera told him that it was correct. *Id.*; TR 1776-77.

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> This "chicken-and-egg" situation ensures that applications will continue to be written for the already dominant Windows, which in turn ensures that consumers will continue to prefer it over other operating systems.

253 F.3d 34, 54 (2001)(citation to record omitted).

The same chicken-and-egg analogy applies here. Premera has used its dominant share of the commercially-insured patients to get bigger discounts from providers and a large network. And the lower provider reimbursements and larger network allow it to sell to more consumers.

All that protects consumers in Eastern Washington from increased Premera premiums are the constraints of OIC regulation and Premera's current pricing policies. But a conversion to a public company would bring new pressures to Premera to improve its operating margins. For-profit companies must shift their focus from the best interests of the subscribers to their own bottom line and shareholder/investors. TR 1102-03, 1115, 1363, 2213-16, 2014, 2152. According to the OIC Staff's investment banker and legal consultants, investors will want to see profits increase and stock values rise. TR 1430, Exhibit S-33 at 58. Public companies are measured by the increase in profit margins. TR 1699-1701, 1738. To increase margins, Premera must either raise rates or lower reimbursement rates. Exhibit S-20 at 120, 122. Dr. Leffler testified that although Premera has market power over provider reimbursements in most parts of Eastern Washington, generally that power appears to have been largely exploited. Exhibit S-17 at 4. Thus, Premera has limited ability to improve margins by further reducing provider reimbursements.

Premera has limited ability to reduce administrative costs. TR 1678-1977; Exhibit S-20 at 121. Thus, Premera will have to rely heavily on increases in premiums to attain higher

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margins. Premera will need to increase rates for the small group (2% to 4%) and individual (8% to 10%) markets in Eastern Washington to meet target margins after conversion. TR 1679, 1955-56, Exhibit S-20 at ES-6. Rates could increase in the individual and small group contract lines in Eastern Washington by at least a few percentage points to meet investor expectations. TR 1955-56, 2000. Dr. Keith Leffler also stated that in parts of Eastern Washington, Premera has the market dominance and the market power to raise premiums above competitive levels. TR 1755, 1764, 1769; Exhibit S-17 at 23, 31-33.

Although Premera is restrained to some extent from increasing premiums in excess of healthcare trend in Eastern Washington due to regulatory considerations, this is not the case where a new plan is introduced in Eastern Washington since it would not be subject to the revenue neutral requirement mandated by Washington law. TR 1031, 1872-75, 2024-26. Thus, Premera would not be required to adjust rates in Western Washington to compensate for rate increases in Eastern Washington.

This means that Premera could raise its rates in excess of the health care trend in Eastern Washington notwithstanding its protestations to the contrary. Premera's board of directors may be compelled to take such action as the result of the fiduciary duty owed to shareholders. Although one cannot predict with certainty Premera's action in this regard, the evidence is persuasive that Premera is likely to increase its rates to satisfy shareholder expectations. The nature of the determination that the Commissioner is required to make under RCW 48.31B.015(4)(a)(iv) and (vi) and 48.31C.030(5)(a)(ii)(C)(II) and (IV) is to predict what the impact of the conversion on subscribers and the insurance-buying public. This was recognized by the Kansas Supreme Court in a similar proceeding in which similar

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statutory standards were applied. *Blue Cross & Blue Shield of Kansas, Inc. v. Praeger,* 276 Kan. 232,75 P.3d 226, 252-253 (2003).

Premera submitted Economic Assurances (Exhibit E-8 to Commissioner's Exhibit 2, Revised Form A Statement) that are proposed to remain in effect for two years from the date of conversion. The assurances are Premera's response to PwC's finding that Premera could raise individual and small group contract premium rates in Eastern Washington to meet target margins. Premera seeks to assuage the Commissioner by promising not to vary its current rate methodology with respect to its individual and small group contracts which, if followed, will not result in rates being increased in Eastern Washington for those lines of business in excess of the healthcare trend. If the Commissioner determines to approve the Form A, the proposed two-year period is woefully inadequate taking into consideration the time needed for the OIC to properly review Premera's compliance with the assurances. TR 1866-75; Exhibit S-69, S-116. Thus, to protect consumers in Eastern Washington from large premium increases, it is important that Premera be required to adhere to a three-year term as a condition if the Form A is approved.

D. The Commissioner should disapprove Premera's application because its implementation will result in entrenchment of the current board of directors and executive management and thus be harmful to the insurance buying public.

Premera's application serves to entrench its current board of directors and executive management thus, creating harm to the insurance buying public. Premera's executives and the board members are positioned to benefit significantly from this conversion. TR 769-70, 771. The greatest portion of the value of the additional compensation will be derived from the issuance of stock options. TR 1382-1383, 1690. Again, despite the incredible testimony of

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persons such as Brian Ancell (TR 843-44), these board members and senior management are likely to be recipients of major financial gains when these options are exercised.

Further, the Blue Cross Blue Shield Association's (BCBSA) rules have the same effect of preserving and protecting current management. The BCBSA's license agreement with Premera states that, "the Plan's (Premera's) license to use the Licensed Marks and Name shall automatically terminate effective: (d) ten business days after individuals who at the time the Plan went public constituted the Board of Directors of the Plan . . . cease for any reason to constitute a majority of the Board of Directors." Exhibit C-2, Exhibit G-20, section 9(d)(iii) at 5a. This requirement firmly entrenches the current board unless Premera wants to risk the loss of the Blues mark.

New Premera's proposed articles of incorporation are designed to ensure that change of the makeup of the board will be kept to a minimum if it occurs at all by dictating when, how, and in what circumstances shareholders or other "outsiders" are allowed to nominate someone for the Premera board. For example, Section 5(b)(2) of Article III of New Premera's proposed articles of incorporation states that, "the individual must be nominated by a shareholder or shareholder group who (i) shall have been the beneficial owner of **more than 5 percent of the corporation's capital stock** for a continuous period of at least two years." Exhibit C-2, Exhibit B-1 at 9. But, the BCBSA restricts individual ownership (not including any member of the BCBSA) to less than 5%, so this provision, by design, can never be fulfilled by an individual shareholder. Only a shareholder group or institutional investor can meet the "more than 5%" requirement.

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However, Section 5(d) of the same article states that "If there is more than one nominating shareholder eligible to nominate a director . . . only the nominating shareholder with the largest beneficial ownership shall be permitted to nominate a director." Exhibit C-2, Exhibit B-1 at 12. This provision allows only one shareholder at a time (the biggest) to nominate potential directors. Furthermore, a shareholder may only nominate a director when a vacancy occurs or when a current director reaches the end of their term. In all other circumstances, any newly created directorships or any vacancies resulting from the removal, resignation, death or a director is filled by an affirmative vote of an independent board majority. Exhibit C-2, Exhibit B-1, section 7, pp. 12-13; TR 1316-17.

Premera has also built into its proposed articles of incorporation, both for New Premera and the foundations, mechanisms that give existing board members control over "people that fit in" with the current demographic by allowing the current board to veto all of the foundations proposed nominees. This attitude became evident when Kent Marquardt testified that "there really needs to be the right chemistry of what the board looks like" in the context of reserving the right to veto all foundation nominees to the board. TR 1133-34.

Premera has asserted that to ensure quality service to subscribers, it must remain a local, independent company. TR 152-153. But quality of service has nothing to do with whether the company is local or independent. TR 153-56. In fact, there are examples of acquisitions of local, independent companies where services or performance were improved after acquisition. TR 501. Further, acquisition is a disadvantage to management because management loses control. TR 499

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Premera has also claimed that conversion is necessary to raise its risk-based capital percentage ("RBC"). Yet its most recent RBC level, 433%, is adequate to continue in business. TR 184. It clearly exceeds the level necessary to operate within the State of Washington. RCW 48.43.300-.325. Further, Premera's RBC level has improved significantly since 2002 as a non-profit and attainment of the 500% RBC level will require capital in an amount less than $72 million. TR 498, 1360. Premera shows no signs of a company that is suffering from capital constraints. TR 1360-61.

That leaves a real concern that the reason for the conversion is to enrich the board and management. TR 2040-41. Such a reason only serves to be a hazard to the insurance buying public.

E. In the event the Form A is approved, 85% of the shares of New Premera should be allocated to the Washington Foundation and 15% to the Alaska Foundation.

As part of the Commissioner's review in this matter, a determination will need to be made of the allocation split between the States of Washington and Alaska. As part of their engagements, The Blackstone Group ("Blackstone") and PricewaterhouseCoopers (hereafter "PwC") reviewed the relevant data to assist the Commissioner in determining a fair allocation of the shares of New Premera between the proposed Washington and Alaska foundations. Statutory RCW 24.03.225 for this. Blackstone conducted an investment banking analysis of relative ownership that resulted in a range for Washington's relative contribution to Premera of 83% to 89%. *See* Exhibit S-5; S-6. PwC engaged in an actuarial analysis that resulted in a range for the Washington foundation's share of the stock of New Premera of 82% to 88% with the midpoint of the range at 85%. *See* Exhibit S-23 at 4, S-24 at ES-4. During his

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testimony, Deputy Commissioner Odiorne recommended adoption at the PwC range midpoint: 85%. TR 2369.

By letter dated May 10, 2004, the Alaska Division of Insurance (hereafter "ADI") Staff accepted the Commissioner's invitation and submitted a statement relating to the allocation issue, which was then offered and admitted into evidence. *See* S-123. The Commissioner granted the OIC Staff's request to respond to the ADI statement. This response was filed on May 25, 2004 and included a review from Blackstone and Memorandum from PwC.

F. In the event the Commissioner is inclined to approve Premera's application, certain additional conditions should be made.

The Commissioner has authority to impose additional conditions on Premera even if he is inclined to approve the application. RCW 48.31C.030(5)(a)(ii)(C). At the hearing, Deputy Commissioner Odiorne described what those additional conditions should be and the reasons for them. TR 2366-82, 2402-53. Those conditions are as follows:

> 1. *Condition the closing on approval of the Alaska and Oregon Insurance Commissioners and any required action by the Washington Attorney General, with 85% of Premera's assets transferring to the Washington Foundation and 35 % to the Alaska Foundation.*
>
> 2. *Eliminate the requirement for the foundations to sell down to 80 % of the outstanding stock by the end of the first year.* Blackstone Group testified that the six month lockout period and any adverse markets could significantly impact the Foundation's ability to sell any stock within the first year. A forced sale to get to an arbitrary percentage is unreasonable, likely to be hazardous and prejudicial to the insurance-buying public.
>
> 3. *Allow each foundation 5% minus one of stock outside of the voting trust.* Each foundation is a separate legal entity, with unique goals, serving a distinct group and these foundations should not be forced to share this 5% vote when each is clearly a separate shareholder.
>
> 4. *Remove the 10% forced sale of the Foundation's stock at the IPO as currently required in the Unallocated Shares Escrow Agreement.* There is absolutely no requirement for this restriction either by rule or statute.

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5. *Uncouple the foundation's divestiture schedules to make them separate and stand-alone schedules.* This will allow each foundation control to sell their stock at a time when they determine is the most advantageous and work to further transfer of fair market value.

6. *Eliminate Premera's ability to veto all of the Foundations' director nominees.* Their argument that this restriction is necessary to ensure the correct "board chemistry" is plainly offensive and wholly unnecessary. The criteria laid out for a board nominee is restrictive enough to ensure that at least one of the three nominees will be suitable.

7. *Retain the Foundations' board representation until its ownership falls below 5% without adding a time limit.*

8. *Eliminate the Voting Trust and Divestiture Agreement if Premera loses its mark.* Premera admitted at the hearing that this would be appropriate if in fact the mark was lost.

9. *Eliminate the automatic extension of the closing date beyond one year.* Premera should be required to seek Commissioner approval for any extensions. Without such a requirement, the fair market value of the foundations' stock may be jeopardized.

10. *Require the approval of solicitation applications.* Both parties agree that this would be required prior to an IPO.

11. *Require receipt and approval of application for solicitation permit for issuing shares under the proposed executive compensation plan.* TR 2380.

12. *Require adequate tax comfort.* Premera should be required to submit a final opinion from Ernest and Young that the conversion shall be treated as a series of tax-free transactions for federal income tax purposes. Additionally, Premera should be required to file a final opinion from Ernest & Young that the conversion transaction should not cause Premera to undergo a material ownership change under Section 382. Finally, Premera would not pass on to policyholders any adverse tax consequences arising from the loss of tax benefits under Section 833(b). TR 2380.

13. *Condition the conversion closing on the Fairness, IPO Procedures and Bring-down opinions by Blackstone.* TR 2379.

14. *Require that the foundations have the right to a free vote on any transfer or issuance of stock involving 20% or more of equity of Premera.* TR 2381-82.

15. *Insure that Washington is afforded the same guarantees as Alaska.* Premera agreed to this condition at the time of hearing.

16. *Require Premera to abide by all the terms of the assurances that the Commissioner accepts and failure to comply with these assurances would be deemed a violation of the Holding Company Acts and subject Premera to the penalties of those Acts.* TR 2380.

17. *That the IPO will close within twelve months of the final approval by the Attorney General of Washington, the Alaska Commissioner, the Oregon Commissioner subject only to extensions granted by the Commissioner on application and good cause.*

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18. *Redefine the disqualification from eligibility for an independent board member if the candidate, or his or her employer, accounts for 2% or $1 million of Premera's revenue, whichever is lesser.* TR 1473-1475, 1289-92.

IV. CONCLUSION

Based on the foregoing as well as the documents, exhibits, and testimony presented at the hearing on this matter, the OIC Staff respectfully request that the Commissioner disapprove the application in its current form. In the event the Commissioner is inclined to approve the application, the OIC Staff request that the additional conditions as proposed by Deputy Commissioner Odiorne at the hearing be imposed on the transaction.

DATED this 28th day of May, 2004.

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BEFORE THE WASHINGTON
OFFICE OF INSURANCE COMMISSIONER

In the Matter of THE APPLICATION REGARDING THE CONVERSION AND ACQUISITION OF CONTROL OF PREMERA BLUE CROSS AND ITS AFFILIATES	No. G02-45 CERTIFICATE OF SERVICE

I, Patti Hamblin, certify that on May 28th, 2004, I served a copy of the following documents:

1. OIC STAFF'S POST HEARING BRIEF
2. CERTIFICATE OF SERVICE

On all parties below as follows:

Service To:	**Service Perfected By:**
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I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 28th day of May, 2004 at Olympia, Washington.

Patti Hamblin, Legal Assistant

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